

Leading Diversity in the Boardroom: Board Evaluation Project 2017¹

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Executive Summary

Listed companies are obligated to conduct annual internal evaluations and triennial external board evaluations. The board evaluation industry is concentrated in a small number of organisations conducting the majority of FTSE 350 companies' evaluations. Recognising the evaluator community has rare and privileged access to Chairs, their boards, and witnessing the impact of boardroom composition, we conducted interviews with 11 experienced board evaluators, operating independently or within firms that offer wider sets of services, to ascertain their views on gender diversity in the boardroom.

Board evaluation can be crudely divided into those focused on more procedural reviews and those engaging with behavioural elements. Our interviews revealed that, through more behaviourally focused reviews, board evaluators demonstrate a deep understanding of the impact they see of group composition on boardroom behaviour, culture and effectiveness. These evaluators were extremely clear about the considerable benefits of a critical mass of diversity in the boardroom (often defined as three 'diverse' individuals). They evidence this through the dynamics of debate and decision-making. Evaluators can advise Chairs on how to optimise the benefits of a diverse board, providing challenge and support, particularly in the areas of feedback, induction and developing a diverse pipeline of talent, in the pursuit of highly effective team performance.

On the understanding that behavioural reviews are more likely to comprehensively address issues of diversity, we suggest that the Financial Reporting Council recommend that board evaluation disclosure in the Annual Report includes information on whether a behavioural or a procedural external evaluation was undertaken, in addition to a summary of actions taken since the evaluation.

We also recommend that the board evaluation industry adopts minimum standards for reviews, in the form of a Code of Conduct, kitemark or other method, by mutual agreement. The minimum standards should address the areas raised in this report, i.e. on diversity and dynamics, culture and behaviour, on feedback, induction and the talent pipeline.

¹ This study was first published in Vinnicombe, Sealy & Humbert (2017) *The Female FTSE Report 2017: Women on boards, back on track?*

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Our findings are unique in terms of behavioural insight into the dynamics of the boardroom and should encourage more Chairs to strive for, and more investors to insist on, maximising the benefits of a critical mass of boardroom diversity.

1.1 Background to the study

“Board evaluation – it’s lifting the lid and having a closer look at the engine”

In 2011 the Financial Reporting Council amended the Code of Corporate Governance introducing elements of reporting on board and senior management diversity in companies’ annual reports. Over the next three years, as part of the Davies Review, we measured compliance levels on diversity reporting³. Such compliance should now form a part of a company’s board evaluation. Earlier this year, the Hampton-Alexander committee questioned whether the board evaluator community plays a role in encouraging gender balance in the boardroom and progress towards the 33% target for FTSE 350 boards by 2020. Recognizing the evaluator community have rare and privileged access to Chairs, their boards, and witnessing the impact of diversity, we conducted 11 interviews with board evaluators, operating independently or within firms that offer wider sets of services, to ascertain their views on this.

Board evaluations became part of the Code of Corporate Governance (the Code) after Sir Derek Higgs’ (2003) review of corporate board effectiveness⁴. In the ensuing 15 years, a small industry has developed around meeting these needs. In 2009, the Walker review⁵ recommended that external evaluations should be undertaken at least every 3 years, with internal evaluations undertaken annually. Walker stopped short of recommending a code of practice for board evaluators, although he strongly encouraged them to professionalise. More recently, the heterogeneity of backgrounds and approaches of board evaluators has been highlighted⁶, and the industry categorized into the ‘behavioural’ and the ‘procedural’.⁷

Today, only 4.6% of all FTSE listed companies declare non-compliance with the triennial external evaluation requirement⁸. In line with earlier years, Grant Thornton 2017 data on corporate governance shows that four board evaluators dominate with 66% market share. The top 10 firms had 78% of the market. In what is often described as a ‘long tail’ distribution, 18% of board evaluations were conducted by firms doing only one FTSE 350 evaluation that year. [N.B. In this report we are only concerned with listed PLCs – the evaluators interviewed may additionally be active in other ownership structures, e.g. private, family-owned, or private equity firms, charities and public sector organisations].

³ Sealy, R.; Turner, C.; Pryce, P. & Vinnicombe, S. (2014) *Women on Boards: Progress following the 2012 Corporate Governance Code*

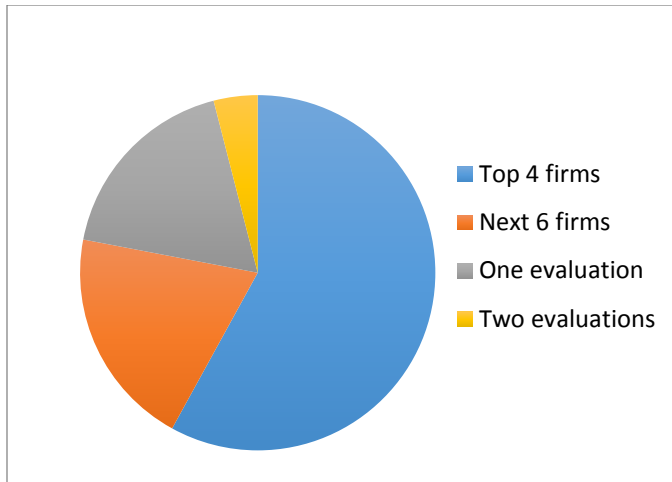
⁴ Higgs, Sir Derek (2003) *Review of the Role and Effectiveness of Non-Executive Directors*, The Department for Trade and Industry

⁵ Walker, Sir David (2009) *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities*, HM Treasury

⁶ Association of British Insurers (2012) *Report on Board Effectiveness, updating progress, promoting best practice*

⁷ Tomorrow’s Company (2016) *Tomorrow’s Corporate Governance, improving board evaluation for greater board effectiveness*

⁸ Grant Thornton (2017) *Corporate Governance Review 2017*



Board Evaluator's Market Share of FTSE 350 companies in 2017

Source: Grant Thornton 2017

1.2 Format of the evaluations

Chairs, along with the Company Secretary, will choose the form of the board evaluation to fit with the context, challenges and lifecycle of the individual board. Heterogeneity of approach is a key feature of the board evaluation industry, a result of the bespoke service they provide. From data driven survey work, to ethnographic observation and one to one interviews, each firm has developed their unique approach to the task of board evaluation.

Broadly, the main elements of the board review are:

- A review of literature, financials, strategy papers, previous reviews, board packs
- Survey/questionnaire of board and key non-board executives
- Interviews with key players, NEDs and EDs. The scope can be widened to include industry regulators, investors and other stakeholders
- Observation of board meeting(s), committees, dinners; two board meetings if dual listed
- A report to Chair and Company Secretary on the board paperwork and processes
- A report to Chair on dynamics, alignment and behavioural elements
- A report to the board, including discussion and action points
- Follow up with the board on action points over the course of the year

The emphasis placed on each element will determine the nature of the evaluator's report. In practice, the outcome of survey-based evaluation and the observational evaluation will be quite different: from "holding up a mirror" to "making the best better".

"I've seen some very effective questionnaires...if we're coming in perhaps on the back of an internal evaluation...it gives you a foundation to build from."

"But people like some data... something that tells them more than just we said this. We got a score of 4.5 on this and we got a score of 7.9... And then people have that to compare with others. But then of course you can't do that because there's no absolutes."

“But over the years the focus has switched away from processes and become much more about relationships, culture, the dynamics in the boardroom, attitudes.”

There are also signs that Chairs and evaluators are self-selecting. All evaluators distanced themselves from the notion of “tick box” or “boiler plate” evaluations. Some said they would not work with Chairs who did not allow full access to papers or board observations, in order to protect their reputation as evaluators. Others were more pragmatic, talking about striking a balance between what they would like and what the Chair wanted. Although the ABI⁹ identified experience, credibility and independence to be of key importance, our interviewees all named **trust** as the key variable when selecting a board evaluator.

With such a variety of approaches comes a large range in cost and interviewees discussed costs to client from under £50k to well in excess of £200k, depending on the range and depth of content. Participants discussed that the different types of methodologies, approaches and experience of the board evaluators could be seen as both a strength and a weakness of this young industry. It is therefore imperative that a Chair understands what s/he is buying – *caveat emptor*.

“...perhaps that’s where we, as an industry, have more that we could do to really explain the differences and the qualities that come, and perhaps the different circumstances when things would work most effectively.”

1.3 Is there an overt focus on diversity in board evaluations?

The Code requires evaluation against diversity reporting. We asked board evaluators at which points in their discussions with Chairs and Company Secretaries did diversity arise. Some Chairs see diversity from a compliance point of view and work hard not to go under 25% women on their boards. Some focused on the diversity of skills required on the boards (e.g. digital), or representative geographical diversity, where relevant to their location or markets. The more sophisticated understanding of diversity, demonstrated by a number of the evaluators, focused on the importance of diversity of board composition and dynamics. For these evaluators, it was their “responsibility to make sure it is on the agenda” and if not, that this “needed unpicking”, in terms of understanding and dealing with the Chair’s resistance to the diversity discussion.

“Have we got the right cast of characters around the table? The question there is about what are the skills required to be on this board, and then diversity comes up right there.”

Best practice was described in terms of the Chair’s ability to combine the need for diverse skills and diverse characteristics. Evaluators were able to contribute suggestions how such gaps might be filled. However, a balance needed to be struck between clever recruitment and asking the impossible, e.g. several evaluators mentioned the rise of “geek girl” to advise on digital matters. However, trying to meet too many agendas with one individual is not realistic.

“We need IT skills, we need marketing skills, so he said if we can get a woman who’s got IT skills and marketing skills that would be great wouldn’t it? So, we’ll get three ticks in one person...we’d never ask

⁹ Association of British Insurers (2012) *Report on Board Effectiveness, updating progress, promoting best practice*

for a man who could do IT and marketing but you think if you can combine all that in a woman wouldn't that be wonderful. Come on, let's get real. You're setting a much higher standard."

"It's having people round the board table that have different backgrounds and different experiences, and have come from different environments because your clients are not all from one gender, or one ethnicity, or one class."

1.4 How does gender diversity affect boardroom behaviours, culture and effectiveness?

Some evaluators demonstrated a deep understanding of the impact of group composition on boardroom behavior, culture and effectiveness. A minority argued it was difficult to attribute such changes to the presence of individuals. The point made by a number of evaluators is that the focus of import is not on the individual behaviour but the difference it makes to the group's behaviour and dynamic.

"Group dynamics is critical to board effectiveness and that always comes back to composition."

"Without a doubt, dynamics is probably one of the biggest areas that we talk about because it's inevitably the critical topic as to the effectiveness of the board...what creates dynamics and then that's are the voices around the table heard, are they balanced, what is the contribution or not, and why is that the way that is? So either why does it work well or why does it not work well, is sort of the core question...that leads you effectively into then what's the composition that's creating the dynamics."

1.4.1 Changing Behaviours

Whilst most evaluators we interviewed were aware of stereotypes and resistant to generalisations, they were also able to make them. These generalisations were consistent across interviews and correlated to the academic research on 'token' behaviours and in-group/out-group dynamics. These included descriptions of women board members as "men in skirts" or "superstars". With one women present there may be "a little less swearing", but there is still "substantial pressure on her to tolerate" inappropriate jokes and comments. "With two women on the board, the Chair will often get their names mixed up. He never gets the male names mixed"; on boards where there are three, "women become authentic and by definition their contribution increases".

Evaluators gave examples of Chairs demonstrating gender-aware behaviour. Good Chairs will be concerned that women are bringing all of themselves into the boardroom to maximize the potential of diversity, and recognize that a diverse range of men is also good for the culture. However, one evaluator pointed to the struggle that some Chairs face with "post diversity" boards – they are unsure whether they should expect women and men to behave the same and whether they can talk about it. Limiting expectations were raised within two particular contexts: the appraisal of performance and the roles women took on. For example, one evaluator described how a woman might be described as either "aggressive" or "ineffective" depending on how often she spoke. When these assessments were challenged, e.g. the comparison made to a male colleague, or by rating the quality of infrequent contribution, male board members were able to recognize the double standards they were holding. There were also examples of women allocated the 'people' role on the board; evaluators could challenge whether this was always appropriate. Women's membership of important committees was

also seen as critical for having influence on the board. Several evaluators mentioned the particular strength of female Senior Independent Directors (SID), acting as go-between for the CEO and Chair, and *“having the Chair’s ear”*. Crucially, however, it was also noted that the SID role, when performed in this way, would not be viewed as a Chair in waiting.

1.4.2 Managing Culture

The Chair is the biggest influence on the culture of the board. His or her actions signal whether the boardroom is a safe place to explore and question ideas, and challenge in a supportive environment. Tangible artefacts can also impinge on culture, such as the shape of the boardroom table. Best practice suggests that this should be round, in order to reduce hierarchy, to enable eye contact between all board members and to facilitate a more inclusive culture.

“In the boardroom it’s all about challenge and support, and striking a good balance. I think with a woman, the nature of challenge can change but also the degree of support, because they can be far more empathetic than men.”

Some evaluators stated that women may be more likely to place an emphasis on *“good culture”*. For example, by thinking about risk holistically, *“getting beyond the financials”*, discussing how a certain strategy will impact on reputation, internally and externally. Another example from an audit committee is thinking about audit holistically, not just about processes. If there is a culture of integrity in the organisation, that provides assurance for the board beyond the focus on good process.

“Because there’s only so much you can do through processes and systems, and so if you don’t have people behaving properly, because the culture says this is the way we behave, you’ll always get a rogue operator...there’s a cultural side and you can’t always catch it in processes and systems and audits”.

1.4.3 Influencing Effectiveness

Some evaluators stated the degree of focus on diversity was dependent on the Chair's interest. Others actively took the challenge to the Chair, framing it directly in terms of effectiveness through dynamics. Unsurprisingly, this was mostly evaluators with a more behavioural focus. These evaluators particularly focused on the dynamics of debate and decision-making.

Voice: The role of the Chair is paramount in determining how effectively diversity improves decision-making. For example, when considering voice (who is heard, is there a dominant voice, does everyone make a contribution?), whether a board benefits from the different voices around the table is a function of how well the Chair manages contributions. How good is s/he at *“encouraging people, giving people a voice”*?

“...it’s balancing the voices to make sure you get to hear from everyone.”

Another example of voices being *heard* was mentioned by some of the evaluators, as an example of ineffective behaviour.

“... if Jane makes a great point and it doesn’t land, and 30 minutes later John says the same point they’ll say, yeah, John’s made a great point here. There’s another one around the table says, John, Jane made that point half an hour ago and you ignored it and now you make it and you’re taking credit for it, why

don't you listen? And you have wasted 30 minutes in getting to that point, the second time. You know, you've got to be as direct as that..."

Challenge: Most of the evaluators were very clear that a reasonable level of challenge was critical for good decision-making and that diversity around the board table was often a pre-requisite.

"A board's got to have some tension in it and that tension has to be positive rather than negative, but if it's all harmonious and everyone says, what a wonderful board, we have great board meetings, we all agree about everything, you think, well are you actually touching the sides? Are you just going down the middle road and never questioning what might happen at the margin?"

"...board members, NEDs, they're friends of the company but there also there to challenge. If you don't get enough challenge, you don't actually get to the heart of issues."

A number of the evaluators suggested that male directors (ED and NED) may feel more comfortable being challenged by a female. However, there was not consensus on why that might be – whether it was the age or ego of the male or simply the different style of challenge used by the female.

"Generally speaking, executives feel far more comfortable with the style of questioning that women tend to adopt. So you can have a male NED and a female NED ask the same question. Women ask it, it's bristly and asked in such a way that the men are oh yes and explain. It's a really good attribute that women have.... Quite often they come across as softer but there's a real hard edge."

Quality of debate: Evaluators also recognize that the quality of debate can be improved by diversity. One described how when a group is homogenous *"they speak in half-sentences"*. 'Diverse' individuals are likely to counter this: e.g. one evaluator described how an NED in a financial services firm could use the fact that they came from a mining background to stop and ask for clarification.

"Where there are people who are outside the club, they would speak in full sentences, they will elaborate more on the points, they will have a fuller discussion. It doesn't necessarily mean that they will tolerate other views, but it means the views are aired and if the out-of-the-club directors are properly empowered, they can question and contribute."

The evaluators were clear that plurality of voice, challenge and quality of debate all contribute to board effectiveness through better decision-making:

"Decision-making becomes more robust if you have women there... they bring a different perspective. If an organisation is thinking of doing a big acquisition, the men will be all over the numbers, the strategy, whereas the women might say well what's the cultural fit going to be like? Of course some women are finance directors and they'll do that, but still they'll ask different questions. They bring a different perspective on risk."

1.5 How can board evaluations support the chair?

Our research supports the key relationship between the Chair and the evaluator in improving board effectiveness. Three areas were identified where evaluators can support Chairs to improve their practice: the use of feedback in the boardroom; the importance of good induction and managing contributions; and the pipeline of diverse talent.

1.5.1 Feedback in the boardroom – Most evaluators said that feedback by and for Chairs, in general, was problematic. Evaluators often offer to give feedback to individual directors, rather than leave it with the Chair. Oftentimes these directors state they have never previously had any meaningful feedback. The Chair receives feedback either from the evaluator or via the Senior Independent Director (SID). It is still not uncommon for the Chair never previously to have received feedback. Most evaluators believed the lack of feedback expertise to be a function of a lack of experience. Today's younger directors have experienced 360 degree feedback for much of their careers and therefore are often better at both giving and receiving feedback. Several evaluators also stated their belief that male Chairs of a certain age find it easier to accept feedback from female evaluators.

1.5.2 Induction – Evaluators stated that good induction was important for all new directors. However, this was especially true for first-time NEDs or those for whom it was their first FTSE 100 board. This is more likely to be the case for 'diverse' candidates. Evaluators spoke of ensuring Chairs support the new director and help them find their voice, enabling them to make the contribution for which they were hired. Chairs also need to manage the extant board directors, to adapt their behaviours to include the new director, making sure "corridor conversations" are also raised in meetings. To reap its full potential, diversity needs to be managed and some evaluators were clear in the support they could give to Chairs in this.

"...appoint a female non-exec director for whom it would be their first non-exec role. They're an up and coming fabulous executive but a lot to learn and my point to the Chairman on the board is to say, she's going to need some support. Your expectation needs to be managed as to she will bring specific expertise, which is what you've asked for. But her contributions won't yet be broader. Are you prepared for that and are you considering that for the dynamic of the team? Because what you don't want is all the board sit there and say, well she's not contributing in the way we want her to...So you need to be very thoughtful about managing the rest of the board around that expectation. Then what are you going to do to actively help her to grow so that her contribution will equally grow as she becomes more established, more experienced and more knowledgeable."

"I suppose a lot of senior members are quite wary of women in the boardroom and the idea of the person from the wrong side of the tracks: this IT guy who hasn't been to Oxbridge, or probably didn't have a degree, but had gone to technical college and was brilliant, and that sort of, he wouldn't fit, or she wouldn't fit and saying well it's not about them adapting to you, you've got to adapt to them."

1.5.3 The Pipeline of diverse talent – Evaluators commented on the tendency to acknowledge 'potential' in men but only 'performance' in women. Contrasts in the available pool of candidates for men and women on boards were made. While men may make up 70% of appointments there is a very large pool from which to choose. Women make up the minority of appointments but competition for those places is correspondingly less. Some evaluators suggested a need to think broadly about where the women can be found, acknowledging that their career paths may be different from a traditional male, as it recognized that, for now, there is a finite number of women in corporate executive roles.

"So the big challenge is how do you appoint a first time NED to your board? If a 44-year old woman hasn't had the experience of being on a board, what's the best proxy for understanding if they'll be any good?"

This is where good advice and support from experienced board evaluators can be invaluable – ensuring good objective appointment processes for “untested” board members.

“And if you do all that you’ve got a much better chance of getting diversity into the boardroom and first time appointments. If we rely solely on people who have got the experience, you can’t move the needle.”

By educating Chairs on how to increase the likelihood of success, evaluators can help increase diversity through successful succession and talent management. A number of the evaluators originated from (but are no longer in) the search industry and therefore are potentially more comfortable also taking this role. Succession was also spoken about below board levels, in terms of managing talent up through the organisation:

“Visibility of the internal sort of pool of individuals and where they may have their succession. So it’s sort of CEO and top team and whether there’s succession into there, and do [the NEDs] have visibility of who they might be.”

And when asked to what extent diversity was a consideration, the general consensus was that *“if there’s an absence of diverse candidates it’s commented upon [by us] as being either a problem or a disappointment.”*

Some evaluators pointed out biased assessments of behavior in boardroom discussions – e.g. how a “standout” female member of the executive committee was harder to recognize as a potential CEO successor because she was less well known than her male colleagues. They had all been promoted through to ExCom, whereas she had been externally appointed. This is of particular interest given that we know from previous research¹⁰ that significantly more men are promoted to ExCom positions and that women are more likely to have to move firms to get to that level.

Summary

Focusing on the softer side of board evaluations - the dynamics, culture and behaviours - our interviewees were able to influence Chairs about the benefits of diversity, how to identify and recruit the optimal composition, and how to get the best from a diverse board in terms of debate, decision making and effectiveness. Best practice means Chairs must leave their comfort zone, to recruit directors with skills relevant to today’s fast moving world. Good board evaluators are able to provide challenge and support to Chairs as they pursue continuing improvement of the board as a high performing team.

1.6 Our Recommendations

Motivation for behavioural change sits with the Chair. For this reason, increased transparency around the Chair’s actions and engagement with the process are likely to be a more effective lever than regulation of the content of the board review. Ultimately the Chair is responsible for the composition, dynamics, culture and behaviours on the board and corresponding quality of debate, decision making and effectiveness. Any recommendations should promote the highest possible levels of trust, challenge and support from the evaluators to the Chair.

¹⁰ Female FTSE Board Report 2014

1.6.1 The Role of the Financial Reporting Council

Evaluators recognized that it was the FRC's role to oversee board effectiveness and that they could do more to regulate the board evaluation industry. A number of suggestions were made, from closer monitoring of board evaluation reports, to actually commissioning board evaluations in certain cases. There was respect for the bespoke nature of board evaluation, based on the judgement of the Chair and Company Secretary, alongside recognition that this approach gave permission for complacency where real improvement was not being sought.

"but there's no absolute measure of board effectiveness, and different boards need different types of effectiveness for different situations."

"If the FRC really wanted to be policeman of this, they would read the board reviews, because it's a requirement to have a board review... They could almost appoint the board effectiveness reviewer to the [weaker] companies... as opposed to allowing the company to choose."

A number of the evaluators felt that the 'old-style' operational reviews (i.e. *"are the board papers right, is the agenda well set, do we have enough meetings a year?"*) are *"necessary but not sufficient for a good board."* One evaluator gave the example of a well-known British bank board before the financial crash saying:

"It's very easy to have a board that ticks all the boxes of operation of excellence but is not making good decisions or is not leading an organisation well."

However, there was agreement that the content of the evaluation must remain confidential if it is to be honest and useful to the Chair: Disclosure of content could push the evaluation back towards a more procedural compliance format. However, there may be value in sharing what actions have been taken following the evaluation.

On the understanding that behavioural reviews are more likely to comprehensively address issues of diversity, we recommend that the FRC consider if board evaluation disclosure in the Annual Report should include information on whether a behavioural or a procedural external evaluation was undertaken in addition to a summary of actions taken since the evaluation.

1.6.2 Evaluating the evaluators

In response to Walker, the board evaluation industry developed a Code of Conduct, which was never formally adopted. Given the structure of the industry, with the 'long tail' of non-specialist providers, addressing the standards for the main players who are already operating at a high level of expertise, may not be an effective mechanism for change. One of our interviewees suggested a 'kitemark' for board evaluation providers that adhere to a minimum set of standards, to overcome information asymmetry about the quality of the board review when the Chair is procuring services.

"It's a difficult one because ... do we have a kitemark that says we're good enough to do this? Are we evaluated on what we do to say we're good enough to do this or we're not good enough to do it, whatever it might be."

“...because there’s no standard set. If you take the comparison to the auditors, there’s a Code of Conduct. If you’re auditing a company there are certain things that you’ve got to do and you’ll be held to account if you don’t do them. On board effectiveness there’s no, we might have written a Code of Conduct, but there’s no absolute set of requirements.”

There was a sense that best practice was *“...moving from the hard to the soft, it is increasingly developing the softer side of what makes individuals effective on a board and what makes a group effective as a group”*.

There was also a strong belief that good quality in-depth feedback was also key *“It’s individual feedback, it’s group feedback and review six months later that make the difference”*. The behavioural elements of effective boardroom dynamics was where the greatest impact of a diverse board could be experienced. However, like diversity generally, the full beneficial effects are only experienced if it is managed well.

We recommend that the board evaluation industry adopts minimum standards for reviews, in the form of a Code of Conduct, kitemark or other method by mutual agreement. The minimum standards should address the areas raised in this report, on diversity and dynamics, culture and behaviour, on feedback, induction and the talent pipeline.

Acknowledgment

We would like to thank sincerely the 11 participants in this study. Interviews ranged from 60-90 minutes, producing 300 pages of transcripts. The summary above reveals high-level initial findings, necessarily limited by space. We will continue to develop this study with a larger sample over the next 12 months. Interviewees were from the following organisations: Advanced Board Excellence, Boardroom Review, B. P. & E. Global, Independent Audit Ltd, Independent Board Evaluation, JCA Group, Lintstock Limited, Manchester Square Partners.